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**COORDINATED ISSUE  
MOTOR VEHICLE INDUSTRY  
SERVICE TECHNICIAN TOOL REIMBURSEMENTS  
UIL 62.15-00**

**ISSUE**

Whether amounts paid to motor vehicle service technicians as reimbursements for the use of the technicians' tools are paid under an accountable plan?

**CONCLUSION**

Generally, amounts paid to motor vehicle service technicians as tool reimbursements will not meet the accountable plan requirements. Amounts paid under a nonaccountable plan are included in the employee's gross income, must be reported to the employee on Form W-2 and are subject to the withholding and payment of federal employment taxes.

**FACTS**

Motor vehicle service technicians (service techs) are hired as employees by dealerships, repair and body shops, and various other enterprises to perform repair and maintenance services on vehicles. As a condition of employment, service techs are required to provide and maintain their own tools, which are kept on-site at the business locations. Generally, the tools are used exclusively by the technician to whom they belong. Service techs are paid hourly wages.

Instead of paying an hourly wage for the performance of services, many employers bifurcate the hourly wage paid to the service techs into "wages" and "tool reimbursements". These plans purport to fall under the aegis of accountable plans as described in Internal Revenue Code (the Code) section 62 and the regulations thereunder. Under I.R.C. § 62(c) reimbursements for employee business expenses meeting certain requirements are not wages includible in income or subject to the withholding and payment of employment taxes. These plans may be administered either by a third party for a fee or by the employer.

In a typical arrangement, the hourly wage paid to the service tech is divided into a wage portion and a tool reimbursement portion. Income and employment taxes are withheld and paid on the wages, but no income or employment taxes are withheld on the tool reimbursement. Employers use various methods to determine the amount paid as tool reimbursement. For example, the method used might measure the hourly value of the

tools the service tech owns multiplied by the number of hours the service tech worked. The method may consider the type of tool, its useful life, original cost or replacement value, geographic location of the worker and other factors. Alternatively, service techs could be paid a tool allowance or advance not based upon the value of the tools or the expenses incurred in use. None of the methods, however, are directly correlated with or based exclusively upon the actual expenses paid or incurred by the service technician for tools. In a typical arrangement amounts paid as tool reimbursements are not reported on Form W-2, but are sometimes reported on Form 1099.

## **APPLICABLE LAW**

### Wages

In general, wages are defined for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA) and income tax withholding purposes as all remuneration for employment unless otherwise excluded. I.R.C. §§ 3121(a), 3306(b) and 3401(a). There is no statutory exception from wages for amounts paid by employers to employees for employee business expenses. However, Treasury reg. § 1.62-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an "accountable plan" are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. Treas. reg. §§ 31.3121(a)-3, 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations, and Treas. reg. § 1.6041-3(h)(1) of the Income Tax Regulations.

### Accountable Plan

Whether amounts are paid under an accountable plan is governed by I.R.C. § 62 which includes the provisions on employee reimbursement or other expense allowance arrangements. Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the-line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee, in connection with his or her performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of I.R.C. § 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under § 1.62-2(c)(1) of the regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of I.R.C. § 62(c) if it meets "the three requirements" set forth in paragraphs (d), (e), and (f) of Treas. reg. § 1.62-2: business connection, substantiation, and returning amounts in excess of expenses.

If an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. Treas. reg § 1.62-2(c)(2)(i). The regulations further provide that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan." Amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes. Treas. reg. §§ 1.62-2(c)(5), 31.3121(a)-3(b)(2), 31.3306(b)-2(b)(2) and 31.3401(a)-4(b)(2).

An arrangement meets the business connection requirement of Treas. reg § 1.62-2(d) if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expenses, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (section 161 through section 196), subchapter B, Chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur business expenses described in paragraphs (d)(1) or (d)(2).

Section 1.62-2(e) of the regulations provides that the substantiation requirement is met if the arrangement requires each business expense to be substantiated to the payor (the employer, its agent or a third party) within a reasonable period of time. As for the third requirement that amounts in excess of expenses must be returned to the payor, the general rule of Treas. reg. § 1.62-2(f) provides that this requirement is met if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated.

Section 1.62-2(k) provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of section 62(c) and the regulation sections, all payments made under the arrangement will be treated as made under a nonaccountable plan.

The Service has not issued any private letter rulings or technical advice memoranda concerning whether a tool reimbursement arrangement meets the accountable plan requirements. However, in a recent unreported decision, *Shotgun Delivery, Inc. v. United States*, No. C 98-4835 SC (January 20, 2000) (*Appeal pending* 9th Circuit), the United States District Court for the Northern District of California granted the government's motion for summary judgment and found that Shotgun's expense reimbursement arrangement with its employees was not an accountable plan within the meaning of I.R.C. § 62(c). The court held that the payments Shotgun made to its employees were wages subject to employment taxes.

In *Shotgun*, the plaintiff, Shotgun, provided courier services. It charged customers an amount, called a tag rate, that was based on distance, time required for delivery, waiting time, and weight. The employees used their own vehicles for deliveries and were paid 40 percent of the tag rate. The couriers were compensated with two separate checks. The first check was a "wage check," which paid the couriers a small hourly amount. The second check was for "reimbursement of expenses/lease fee" and equaled 40% of the tag rate minus the amount paid on the wage check. Thus, couriers were always paid 40% of the tag rate. The court found the arrangement was not an accountable plan because it failed to meet the business connection requirement. Under its arrangement, the plaintiff reimbursed its drivers regardless of the actual miles driven or expenses incurred. The court concluded that "as Shotgun's reimbursement arrangement had no logical correlation to actual expenses incurred it was an abuse of section 62(c) and was therefore a nonaccountable plan." That same reasoning applies to tool reimbursements where a portion of the service techs's hourly wage payment is designated as a tool reimbursement, but the amount has no logical connection to the expenses incurred. In the typical tool reimbursement arrangement the employer carves out a portion of the worker's hourly wage and recasts it as reimbursement for expenses, when in fact the amount treated as reimbursement is not related to the employee's expenses.

## DISCUSSION AND ANALYSIS

Employers typically claim reliance on Rev. Rul. 68-624, 1968-2 CB 424, as authority for designating a portion of an employee's compensation as a payment for the use of tools and excluding that amount from wages. Rev. Rul. 68-624 considers what percentage of the total amount paid by a corporation for the use of a truck and the services of a driver is allocable as wages of the driver for FICA purposes. The facts specify that the corporation hires a truck and driver to haul stone from its quarry to its river loading dock at a fixed amount per load and allocates one third of the amount paid the employee as wages and two thirds as payment for the use of the truck. The ruling holds that an allocation of the amount paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment does not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation may be arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

Although Rev. Rul. 68-624 has not been obsoleted, it should not be relied upon to exclude tool reimbursement payments for service technicians from wages. The analysis in Rev. Rul. 68-624 does not comport with current law because it does not consider the application of I.R.C. § 62(c). Under current law, tool reimbursements can be excluded from wages only if paid under an accountable plan. An employment contract that merely allocates compensation between wages and tool reimbursements will not satisfy the requirements of I.R.C. § 62(c). To exclude employee reimbursements or other expense allowance payments from wages, an employer must

establish an accountable plan. An arrangement will qualify as an accountable plan if it meets the three requirements of business connection, substantiation, and return of excess.

Treas. reg. § 1.62-2(d)(1) specifies that the business connection requirement is met only if the arrangement provides advances, allowances or reimbursements for business expenses that are allowable as deductions and are paid or incurred by the employee in connection with the performance of services as an employee of the employer. Thus, not only must an employee pay or incur a deductible business expense, but the expense must arise in connection with the employment. If an employer reimburses a deductible tool expense that the employee paid or incurred prior to employment, the reimbursement arrangement does not meet the business connection requirement. Further, if an employer pays an advance or allowance based on, for example, fair tool rental value, regardless of whether the employee incurs (or is reasonably expected to incur) the type of business expenses described above, the reimbursement arrangement does not meet the business connection requirement. Since service techs are generally required to provide their own tools as a condition of employment, expenses paid or incurred in connection with the tools would constitute ordinary and necessary deductible employee business expenses if not reimbursed. "Paid or incurred" requires that there be an actual expense, not fair rental value or use or some other intangible figure, with which the advance, allowance or reimbursement is associated. In the case of an advance or allowance, the payment by the employer may precede the incurring or payment of the specific expense by the employee, assuming the substantiation requirements are met in a timely manner.

Treas. Reg. § 1.62-2(e)(1) requires that each business expense be substantiated to the payor within a reasonable period of time. Treas. reg. § 1.62-2(g)(1) indicates that, in general, the determination of a reasonable period of time will depend on the facts and circumstances; however, Treas. reg. § 1.62-2(g)(2) provides a safe harbor allowing an advance to be made within 30 days of an expense, substantiation of paid or incurred expenses within 60 days, and the return of excess reimbursements within 120 days of payment or incurring. It is clear from these regulations that an advance or allowance is not intended to be open-ended or unassociated with specific, otherwise deductible, expenses. Amounts paid by the employer not representing specific expenses that are actually incurred by the employee fail to meet the terms of an accountable plan and are considered wages.

In addition to the requirement that substantiation be made on a timely basis, such substantiation of expenses must be detailed and complete. Treas. reg. § 1.62-2(e)(2) requires that, for expenses governed by I.R.C. § 274(d), the employee must submit information sufficient to satisfy the requirements of I.R.C. § 274(d) and the regulations, which deal with substantiating the amount, time, place, and business purpose of the expenses to the employer by adequate records. Treas. reg. § 1.62-2(e)(3) requires that, for expenses not governed by I.R.C. § 274(d), the employee must submit information sufficient to enable the employer to identify the specific nature of the expense and to conclude that the expense is attributable to the employer's business

activities. Fair tool rental value, regardless of the accuracy of its estimation, does not satisfy this requirement, as it does not provide any information about the amount of, or the specific nature of, any expenses paid or incurred by the employee.

The requirements set forth in Treas. reg. § 1.62-2(f) regarding the return of amounts in excess of expenses further clarify that only expenses actually paid or incurred may be treated as paid under an accountable plan. Employees are required to return to the payor within a reasonable period of time any amount paid in excess of expenses substantiated. This section specifies that an arrangement advancing money to an employee to defray expenses will satisfy the requirements of an accountable plan only if the amount of money is reasonably calculated not to exceed the amount of anticipated expenditures and the advance is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred. A regular, routine allowance or advance for the rental value or use of tools would not meet this requirement.

Each tool reimbursement arrangement should be reviewed to determine whether the accountable plan rules are met. In addition to the factors previously discussed, there are other factors to take into account. It is relevant to know when the employer began compensating its employees in part with a tool reimbursement program. It should be ascertained whether the arrangement is written, and, if so, the writing should be reviewed to determine if its terms comply with the requirements of an accountable plan. Such writing may be in the form of a lease, an employee handbook, or an employment contract. Whether the written terms of the arrangement are actually followed is important. The service technicians' understanding of the arrangement also should be considered. Employers frequently assert that it is industry practice to pay service techs for the use of their tools. There is no "industry practice" exception to the accountable plan requirements. After analyzing the tool reimbursement arrangement, a determination can be made whether it meets the accountable plan requirements.